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Memorandum

Section 367(d), Intangibles, and Base Erosion: A Reassessment

by Layla J. Aksakal, Esq., and Rocco V. Femia, Esq.
Miller & Chevalier Chartered
Washington D.C.

INTRODUCTION

U.S. policymakers have devoted considerable attention in recent years to transfer pricing and base erosion. That attention has included high-profile enforcement actions under current law,[1] regulatory changes,[2] an active regulatory project promising more changes,[3] and legislative proposals.[4] At the center of much of this activity is the operation of §367(d) and, in particular, the longstanding exception from the definition of intangible property for foreign goodwill and going concern value. In addition, the IRS recently issued guidance under §367(d) to address repatriation techniques.[5]

This article examines the enforcement and regulatory activity in light of the concerns animating the enactment of §367(d) and the establishment of the exception for foreign goodwill and going concern. The article proposes a basic framework for interpretation and regulation in this area given the policy compromises reflected in this history, and sets out factors for policymakers to weigh when considering legislative proposals.

In sum, §367(d) was enacted as a backstop to clear reflection of income principles. The intention of Congress was to curtail the ability of taxpayers to deduct intangible development costs against U.S. income and later to defer the U.S. tax on income associated with the successful exploitation of the developed intangible property. In this regard, the purpose of §367(d) is modest and is consistent with other exceptions in §367(a) to the tax-free treatment of outbound transfers of foreign trade or business assets. These rules were not intended to impose a general exit tax upon the outbound transfer of appreciated business assets or the incorporation of a foreign branch; rather, they were intended to claw back any U.S. tax benefits related to the assets or of having operated in branch form. Section 367(d) was not intended as a backstop to the transfer pricing rules or the subpart F rules, each of

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[1] *See, e.g.,* Notice 2005-21, 2005-1 C.B. 727 (providing guidance regarding so-called §936 exits), and Coordinated Issue Paper — Sec. 482 CSA Buy-In Adjustments, LMSB-04-0907-62 (9/27/07) (since withdrawn, providing guidance to Exam on addressing cost sharing buy-in issues) (''Cost Sharing CIP''). All section references herein are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

[2] See Regs. §1.482-7T, 74 Fed. Reg. 236 (1/5/09), since finalized.

[3] *See* U.S. Department of the Treasury, Office of Tax Policy and Internal Revenue Service, 2012–2013 Priority Guidance Plan (''Priority Guidance Plan'') (International Issues, Item C.2.: Regulations under §367(d) regarding transfers of intangible property to foreign corporations). This item has been on the priority guidance plan since the 2010–11 Priority Guidance Plan.

[4] *See* U.S. Department of the Treasury, ''General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals'' (April 2013) (''FY 2014 Greenbook'') at 49 (proposal to ''Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore'') and 51 (proposal to ''Limit Shifting of Income Through Intangible Property Transfers; and International Tax Reform Discussion Draft issued by Ways and Means Committee Chairman Dave Camp (including three alternative proposals to address base erosion) (October 2011) (''Ways and Means Discussion Draft'').

[5] Notice 2012-39, 2012-31 I.R.B. 95.

which serve different and broader base erosion purposes, and caution should be taken in using §367(d) as a tool to address potential deficiencies in those rules or other rules. Further, although §367(d) (like §367 overall) has a role to play in adapting domestic nonrecognition rules to the cross-border context, even in that context it is appropriate to ask whether issues unique to intangible property are presented and therefore best addressed by §367(d).

As a policy matter, the balance represented by §367(d) may or may not be appropriate depending on one's view of the objectives of the international tax rules. It may be that §367(d) should be more tightly focused on intangibles that present the mismatch issue that led to its enactment, or that the rules should be amended and extended to the transfer of any assets or business attributes that have some potential to generate non-routine profits.

CURRENT FOCUS ON §367(d)

Overview of Statutory and Regulatory Guidance

Section 367(a) provides general rules governing the taxation of outbound transfers of property by U.S. persons to foreign corporate transferees in transactions that would qualify as nonrecognition transactions if the transferee had been a U.S. corporation. In general, the transfer of property by a U.S. person to a foreign corporate transferee in such transactions will qualify for non-recognition treatment if such assets will be used by the transferee in an active trade or business outside the United States.[6] There are numerous statutory exceptions to this general rule of nonrecognition where assets to be used in the transferee's non-U.S. business, such as for assets that are expected to turn over quickly (such as inventory and accounts receivable),[7] for gain to the extent necessary to recapture non-economic depreciation[8] or branch losses[9] taken against U.S. income, and, notably, for intangible property.[10] Intangible property is defined by reference to the enumerated statutory list of items in §936(h)(3)(B), and therefore refers to any of the following items so long as it has value independent of the services of any individual: ''patent, invention, formula, process, design, pattern, or know-how; copyright, literary, musical, or artistic composition; trademark, trade name, or brand name; franchise, license, or contract; method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or any similar item.''[11] The statute explicitly provides regulatory authority to carve back the definition of intangible property for this purpose, or otherwise to extend nonrecognition treatment to transfers of intangible or other property.[12]

Section 367(d) provides special rules for the taxation of outbound transfers of intangible property by a U.S. person to a foreign corporation in an exchange that otherwise would qualify as a nonrecognition transaction under §351 or 361. Consistent with §367(a), §367(d) explicitly provides regulatory authority to carve back recognition of gain; thus, regulations could exempt certain items from the list of intangible property, or could exempt certain categories of taxpayers or transactions from the rules of §367(d) altogether.[13] Also consistent with §367(a), the term ''intangible property'' is defined by reference to the enumerated statutory list in §936(h)(3)(B). Long-standing temporary regulations define ''intangible property'' for purposes of §367 to mean ''knowledge, rights, documents, and any other intangible item within the meaning of section 936(h)(3)(B)'' so long as such item constitutes property for purposes of the applicable nonrecognition rule.[14] There is a regulatory exception to the rules of §367(d) for foreign goodwill and going concern value, as well as for certain other items (copyrights, artistic compositions, or letters or memoranda) to which specific rules apply.[15]

Accordingly, a U.S. person can transfer foreign goodwill and going concern value to a foreign corpo-

[6] *See* §367(a)(3)(A).

[7] §367(a)(3)(B)(i) and (ii).

[8] Regs. §1.367(a)-4T(b). The legislative history of §367 indicates a clear intention on the part of Congress that the Treasury Department issue regulations to require recapture of depreciation deductions with respect to assets used in the United States. *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 955 (1984), *reprinted at* 1984-3 C.B. Vol. 2, 209.

[9] §367(a)(3)(C).

[10] *See* §367(a)(3)(B) and (d).

[11] *See* §367(a)(3)(B)(iv); *see also* §936(h)(3)(B).

[12] *See* §367(a)(3)(B) (providing a list of items of property excepted from the active trade or business test ''[e]xcept as provided in regulations prescribed by the Secretary'') and §367(a)(6) (providing regulatory authority to except any transaction from the rules of §367(a)).

[13] *See* §367(d)(1) (providing rules for certain outbound transfers of intangible property ''[e]xcept as provided in regulations prescribed by the Secretary'').

[14] Regs. §1.367(a)-1T(d)(5)(ii). The nonrecognition rules apply only to transfers of property. Transfers of items that do not constitute property (e.g., the provision of services) are not within the scope of the nonrecognition rules. *See E.I. Du Pont de Nemours and Co. v. U.S.*, 471 F.2d 1211, 1218–19 (Ct. Cl. 1973) (citing ''generous definition of 'property' '' in tax law for purposes of applying §351 to a transfer of a nonexclusive license), *Hospital Corp. of America v. Comr.*, 81 T.C. 520 (1983) (negotiation and other support in the context of making available a business opportunity was a provision of a service and not a transfer of property within the meaning of §351).

[15] *See* Regs. §1.367(d)-1T(b).

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rate transferee (in the context of the transfer of other business assets) tax free. As explained further below, this regulatory exception has its roots in the legislative history of §367(d). It is not clear as a technical matter whether goodwill and going concern value otherwise would be intangible property as defined in §936(h)(3)(B) and the regulation is intended merely to confirm this result, or whether the regulation is a grant of administrative grace pursuant to the statutory authority to carve back the application of §367(d).[16]

Intangible property that is taxable under §367(d) is subject to rules akin to the transfer pricing rules. Section 367(d) requires that the income from the transfer of intangibles be commensurate with the income from the intangibles transferred, a requirement that echoes the standard in the second sentence to §482 (which references the same enumerated statutory list of intangible property of §936(h)(3)(B)). Temporary regulations provide that the transferor must take into income an amount that represents an appropriate arm's-length charge for the use of the transferred property in each year over the useful life of the property.[17] Useful life is defined as the period during which the property has value, but not to exceed 20 years; the useful life of legally protected property such as a patent terminates when the property is no longer legally protected.[18] Finally, the temporary regulations provide a deemed sale election for transfers of certain operating intangibles, intangibles required to be transferred under foreign law, or intangibles transferred to certain joint ventures with third parties.[19] In cases where the deemed sale election applies, the transferor must include in income any built-in gain in the intangibles transferred.

Recent Administrative Developments

The scope of §367(d), and in particular the regulatory exception for goodwill and going concern value, has been the subject of administrative focus and controversy in a variety of settings in recent years. Further, the IRS has provided guidance on the interplay of §§367(d) and 367(a) in the context of arrangements that the IRS perceived as repatriation techniques. Each topic is discussed briefly in turn below.

Controversy Regarding Scope of §367(d)

Taxpayers and the IRS have taken different positions regarding the scope of §367(d), and in particular the scope of the regulatory exception for foreign goodwill and going concern value, in several contexts in recent years. Predictably, taxpayers have tended to interpret narrowly the enumerated items designated by the statute as intangible property, and to interpret broadly the exception for goodwill and going concern value. The IRS has tended to take the opposite position. This divergence has led to considerable controversy.

For example, in TAM 200907024, the IRS National Office concluded that the synergistic value of a network of foreign contractual arrangements transferred outbound in the context of a global delivery business was attributable to the contracts and therefore subject to tax at the time of transfer under §367(d).[20] The taxpayer had taken the position that this synergistic value was noncompensable foreign goodwill or going concern value within the meaning of those terms as used in the regulations because it represented the value of the assemblage of identifiable assets. The taxpayer's position would have allocated 97% of the value of the transferred assets to goodwill or going concern value. The IRS made several arguments in support of its position. First, it argued that the regulatory definition of goodwill and going concern value provides that such items represent the residual value of the foreign business once all identifiable tangible and intangible assets, including in this case the contracts, are identified and valued. Because the contracts should be valued in the aggregate and not contract by contract, all of the residual value of the foreign business in effect was allocated to the contracts and not to goodwill or going concern value. The IRS further argued that the network of contracts itself may be intangible property under §367(d) as a franchise, method, system, program, procedures, or similar item. Finally, and perhaps most interestingly, the IRS asserted that the tax-

[16] Whether foreign goodwill and going concern value is characterized as intangible property under §367(d) is a matter of debate. Some commentators have argued that goodwill and going concern value are not items included in the §936(h)(3)(B) definition of intangible property. *See, e.g.,* David N. Bowen, "Full-Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade? A Critical Analysis of the Scope of §§482, 367(d), and 936(h)(3)(B) in Relation to Goodwill, Going Concern Value, and Workforce in Place," 37 *Tax Mgmt. Int'l J.* 3 (1/11/08); Thomas M. Zollo, "Clarification or Modification? The Tax Treatment of the Outbound Transfer of Goodwill, Going Concern Value, and Workforce in Place to a Foreign Corporation," 39 *Tax Mgmt. Int'l J.* (2/12/10). In contrast, others have argued that foreign goodwill and going concern value is §936(h)(3)(B) property and is therefore subject to §367(d) and not §367(a). *See* Martin J. Collins, David J. Sotos, and Sean W. Mullaney, "Revisiting Certain Fundamentals in Light of the New Wave of Outbound Reorganization Guidance," 42 *Tax Mgmt. Int'l J.* 21 (1/11/13). Recently issued regulations clarify that all property is subject either to §367(d) or §367(a). *See* Regs. §1.367(a)-7(f)(10) and (11); *see also* 78 Fed. Reg. 17024, 17026 (3/19/13).

[17] Regs. §1.367(d)-1T(c)(1).

[18] Regs. §1.367(d)-1T(c)(3).

[19] Regs. §1.367(d)-1T(g)(2).

[20] The facts of TAM 200907024 are similar to those in *First Data Corp. v. Comr.*, Tax Ct. Dkt. No. 7042-09, which was settled in late 2011. The IRS had proposed transfer pricing adjustments and penalties of over $2 billion, and parties settled at approximately half that amount. Penalties were dropped.

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payer's position violated the fundamental policy of §367(d) ''because treating ninety-seven percent of the value of the Network as foreign goodwill or going concern value would allow a virtually tax-free transfer of valuable intangible property that was developed by incurring significant expenses that reduced income otherwise taxable in the United States.''

Similarly, the IRS has focused on the scope of §367(d) as applied to deemed or actual transfers of intangible property in the context of so-called §936 exits. Under prior law, U.S. corporations with operations in U.S. possessions, typically Puerto Rico, constituted §936 corporations and received a credit against U.S. taxes attributable to income from businesses conducted in a U.S. possession. The credit was phased out for taxable years beginning after 1995 and before 2006. As a result of this phaseout, taxpayers began restructuring their operations involving possession corporations. These restructurings often involved the creation of new controlled foreign corporations with branches in Puerto Rico and subsequent deemed or actual transfers of intangibles from the former §936 corporation to the newly created subsidiaries.

The IRS regards §936 exits as a significant compliance issue. Notice 2005-21[21] and three subsequent directives provide insights into how the IRS views §367(d) in the context of §936 exits. Notice 2005-21 addresses the treatment of intangible property where the former §936 corporation is converted to a foreign subsidiary with operations in Puerto Rico, providing generally that the transfer of intangible property from the former §936 corporation to the successor foreign corporation will trigger §367(d). The first industry directive on this issue, issued February 2, 2007, notes that while the transfer of foreign goodwill and going concern value is not subject to tax under §367(d), examiners should scrutinize taxpayer attempts to treat a significant portion of the value of transferred intangibles as foreign goodwill or going concern value. Further, in the case of §936 conversions, ''it may be appropriate to consider whether claimed foreign goodwill and going concern value is really foreign. It may be that these intangibles are goodwill and going concern value, but are not foreign and thus are subject to tax.''[22] The second industry directive, issued February 13, 2008, notes further that most of the controversial issues arising from a §936 reorganization involve the transfer of intangible assets by the possession corporation in transactions subject to §367(d) and the scope of the regulatory exception to §367(d) for foreign goodwill and going concern value. The second directive further restates the IRS position that workforce-in-place is properly treated as an intangible under §936(h)(3)(B) and should not be viewed as part of foreign goodwill or going concern value.

Several cases involving §936 exits are pending in the U.S. Tax Court. In each case, the taxpayer is contesting, among other things, adjustments based on §482 and, in the alternative, §367(d).[23]

Section 367(d) and Cost-Sharing Buy-In Payments

Under the pre-2009 cost sharing rules, buy-in payments were required to be paid to participants in a cost sharing arrangement that made available ''pre-existing intangibles'' to the arrangement for use in developing new cost shared intangibles.[24] Significant controversy has arisen regarding the scope of the term ''pre-existing intangibles,'' the interrelationship with §367(d) and the exception for foreign goodwill and going concern value, and appropriate valuation methodologies.[25] The IRS took the position in the Cost Sharing CIP that all of the expected non-routine returns from the foreign business in which the cost shared intangibles will be exploited must be allocated to the person making available the pre-existing intangibles in the buy-in transaction.[26] Consistent with the guidance in the context of §936 exits, the IRS took the position that examiners should scrutinize taxpayer attempts to treat a significant amount of the value as attributable to foreign goodwill and going concern value and therefore transferable tax-free.[27] The IRS developed numerous cases consistent with these

[21] 2005-1 C.B. 727.

[22] Note that the outbound transfer of ''U.S.'' goodwill or going concern value may be taxable under the general rules of §367(a), which provide tax-free treatment to transfers of property only where it will be used in an active trade or business outside the United States. See Zollo, above, note 16.

[23] *See Boston Scientific Corp. v. Comr.*, Tax. Ct. Dkt. No. 26876-11; *Guidant LLC v. Comr.*, Tax Ct. Dkt. No 5989-11 and *Cardiac Pacemakers v. Comr.*, Tax Ct. Dkt. No 5990-11 (Guidant LLC was formerly Guidant Corporation, the parent company of a consolidated group that included Cardiac Pacemakers. Boston Scientific acquired Guidant in 2006, after the years at issue in these cases.); *Medtronic Inc. v. Comr.*, Tax Ct. Dkt. No. 6944-11; and *Eaton Corp. v. Comr.*, Tax Ct. Dkt. No. 5576-12.

[24] Regs. §1.482-7(g)(1) (1996).

[25] *See generally* Bowen, above, note 16.

[26] *See* Cost Sharing CIP, above, note 1 (The income method ''determines the value of the buy-in intangible (along with any licensed make-sell rights) as the present discounted value of the stream of projected operating profits of the [foreign affiliates], after reduction by routine returns and projected cost sharing payments for the [foreign affiliates'] share of the R&D projected under the [cost sharing arrangement].'').

[27] *See* Cost Sharing CIP (''The value of such foreign goodwill or going concern value, to the extent it exists, does not include substantial residual intangible value associated with the right to exploit foreign markets that, instead, belongs to other identifiable intangibles'').

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views. In *Veritas Software Corp. v. Comr.*,[28] the Tax Court rejected the IRS's approach to the buy-in issue. While the result in *Veritas* did not turn on an application of §367(d), the rejection of the IRS's position is based on the court's conclusion that the appropriate focus of the buy-in inquiry is the §936(h)(3)(B) intangibles actually transferred by the taxpayer, and not the expected non-routine returns from the taxpayer's foreign business. The IRS objected to, but did not appeal, the *Veritas* decision.[29] It withdrew the Cost Sharing CIP, but continues to pursue cases under the pre-2009 regulations. A case recently has been docketed in the Tax Court.[30]

Effective beginning in 2009, revised cost sharing regulations substantially alter the legal framework in which the buy-in issue arises.[31] The regulations adopt the positions taken by the IRS in litigation under the old regulations, providing under an ''investor model'' that all foreseeable residual profits from intangible development are allocated to persons making available any ''resource, capability, or right'' that is reasonably anticipated to contribute to developing cost shared intangibles. This ''platform contribution transaction,'' or ''PCT,'' is not limited to the transfer of intangibles listed in §936(h)(3)(B), and the intended interaction with §367(d) and the exception for foreign goodwill and going concern value is not clear. Consistent with the broad scope of PCTs, the regulations adopt valuation methodologies suited to capture the aggregate value of these contributions, including the income and acquisition price methods, and provide periodic adjustment rules similar to those applicable to intangible property transfers under the commensurate with income standard. In this regard, the preamble to the final regulations contemplates an aggregate valuation for all transfers, including those structured as §351 contributions, as the most reliable approach. As an example, the preamble posits transfers of intangibles by one participant to another in a transaction governed by §367(d), and explains that the pricing of those intangibles may need to be evaluated along with the contributions with respect to the cost sharing arrangement on an aggregate basis.[32] The final regulations leave open the question of how (or whether) taxpayers should remove the value of foreign goodwill and going concern value, as well as other noncompensable resources, capabilities, or rights, from the aggregate valuation.

[28] 133 T.C. 297 (2009).

[29] AOD 2010-49 (12/6/10).

[30] *See Amazon.com Inc. v. Comr.*, Tax Ct. Dkt. No. 31197-12.

[31] *See* Regs. §§1.482-7 and -7T.

[32] T.D. 9568, 76 Fed. Reg. 80082, 80082–83 (12/22/11).

Use of §367(d) to Curb Repatriation Techniques — Notice 2012-39

In July 2012, the IRS announced in Notice 2012-39[33] that it would issue regulations to restrict the repatriation of earnings through outbound cash D reorganizations when the target's assets consist of intangible property subject to §367(d). One effect of Notice 2012-39 is to tax currently cash received, or certain liabilities assumed, in connection with an outbound transfer of intangible property as a prepayment of the deemed royalty that §367(d) would otherwise impose over the useful life of the intangible property.

Ordinarily, under the ''boot within gain'' rule, cash received as boot in an asset reorganization is taxable only to the extent of the transferor corporation shareholder's gain in the target stock.[34] Therefore, if the target was recently acquired and the U.S. shareholder has no gain in its stock, §356 may provide an opportunity for tax-free repatriation in the context of an outbound asset reorganization.[35] Furthermore, if the target's assets consisted of intangible property, taxpayers took the position that the boot-within-gain rule prevented gain recognition in the year of transfer while §367(d) not only postponed income inclusions until subsequent years but also permitted corresponding tax-free cash remittances in those years. In the government's view, the transaction enabled tax-free repatriation by permitting the U.S. taxpayer to be paid twice, and taxed only once, for the intangible property that it transferred outbound.[36]

Notice 2012-39 is intended to curtail this repatriation technique by requiring the U.S. corporate asset transferor to include in income currently the cash intended to be treated as boot in the reorganization. This cash payment is considered a prepayment of income that would ordinarily be included over time under §367(d) and is taxed in the year of the outbound transfer regardless of the productivity of the intangible property in the future.[37]

Notice 2012-39 also addresses the mechanical operation of §367(d) in cases where a U.S. transferor

[33] 2012-31 I.R.B. 95.

[34] *See* §356(a). In its FY 2014 budget proposal, the Obama administration proposed repeal of the boot-within-gain rule. *See* FY 2014 Greenbook, at 91. Similar legislative proposals have been introduced in the past. *See, e.g.,* H.R. 62, International Tax Competitiveness Act of 2011.

[35] If the target has built-in gain in its assets (other than intangible assets subject to §367(d)), regulations under §367(a)(5) would require the target to recognize gain to the extent the U.S. shareholder cannot preserve that gain in its shares of the foreign transferee corporation because the U.S. shareholder's share of inside gain exceeds the fair market value of the stock received in the reorganization. *See* Regs. §1.367(a)-7(c)(2)(ii).

[36] *See* Lee Sheppard, ''Intangibles Prepayment Theory Will Apply to Pre-Notice Transactions,'' 2012 *TNT* 202-1 (10/18/12).

[37] Under the temporary regulations, a U.S. person that is sub-

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ceases to exist and a ''non-qualified successor'' (i.e., a shareholder other than a domestic corporation) to the U.S. transferor receives stock in the transferee foreign corporation. For example, if the stock of the U.S. transferor is owned 95% by a domestic corporation and 5% by a foreign corporation, an outbound reorganization of the U.S. transferor generally requires the U.S. transferor to recognize gain under §367(a)(5) to the extent of its foreign shareholder's 5% interest in its active trade or business assets. Prior to Notice 2012-39, however, there was no corresponding rule with respect to intangible property subject to §367(d). Notice 2012-39 conforms the treatment of intangible property to the treatment of other active trade or business assets in such a transaction by requiring a current income inclusion under §367(d) to the extent of the non-qualified successor's share of gain on the §367(d) property transferred in the exchange. Final regulations confirm furthermore that in such transactions, section 367(a)(5) requires gain recognition with respect to all property other than ''section 367(d) property,'' defined as ''property described in section 936(h)(3)(B),'' and that Notice 2012-39 applies to §367(d) property.[38]

Regulatory and Policy Focus

Section 367(d) Regulation Project

Temporary regulations under §367(d) were issued in 1986, with modest revisions in 1998 in connection with regulations dealing with certain stock transfers. The temporary regulations therefore do not reflect policy developments since the extension of §367(d) to all outbound transfers of intangibles in 1984. For example, the regulations state in several places that an income inclusion under §367(d) is U.S.-source income, consistent with an express provision in the statute as initially enacted.[39] Congress abandoned that sourcing rule more than 15 years ago, however, and the regulations have been superseded by statutory changes that conform the sourcing of a deemed royalty under §367(d) with that of an actual royalty.[40] As noted above, the regulations dictate that deemed royalties pursuant to §367(d) must be paid annually over the useful life of the transferred intangible property, define the useful life of intangible property, and provide that a taxpayer can elect to treat an outbound transfer of operating intangibles and certain other intangibles as a sale for a lump sum without the possibility of subsequent adjustments.[41] It would be appropriate to revisit these rules in light of the introduction of the commensurate with income standard in both §§367(d) and 482 in 1986 and subsequent regulatory developments under §482.[42]

In light of these developments, as well as the increased focus on outbound transfers and base erosion, Treasury and the IRS announced a regulatory project on §367(d) in 2010. That project is pending.[43]

Legislative Activity and Proposals

Both Congress and the Administration in recent years have focused on base erosion and the outbound transfers of intangible property. Several hearings on the issue have been held, most notably a hearing on income shifting before the Ways and Means Committee in July 2010. The Joint Committee on Taxation prepared a report for that hearing that focused on six case studies derived from actual taxpayer information. Each of these cases featured the transfer of intangibles developed in the United States to deferral vehicles — that is, to foreign subsidiaries whose income is not subject to current U.S. tax under the anti-deferral rules of subpart F. Indeed, in each case the deferral vehicle was part of a foreign principal structure designed to allocate residual profits to a low-tax foreign entrepreneur or principal in a manner that did not give rise to current inclusions under subpart F. In one case, the taxpayer attributes almost all of the value of foreign business operations transferred outside the United States during the review periods to foreign goodwill and going concern value.[44]

The Administration has proposed legislation to ''limit shifting of income through intangible property transfers.''[45] This proposal would expand the scope of intangible property for purposes of §§367(d) and 482 to include ''workforce in place, goodwill, and going concern value.'' The proposal also would codify cer-

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ject to §367(d) is permitted to establish an account receivable from the transferee foreign corporation for deemed royalties, and the transferee foreign corporation may make payments of these amounts without further U.S. income tax consequences to the U.S. transferor or foreign transferee corporation. *See* Regs. §1.367(d)-1T(g)(1)(i).

[38] Regs. §1.367(a)-7(f)(10) and (11); 78 Fed. Reg. at 17026 (3/19/13).

[39] *See* Regs. §1.367(d)-1T(c)(1), (d)(1), (e)(1)(iii), (f)(1)(i), (g)(2).

[40] *See* §367(d)(2)(C), as amended by P.L. 103-557 (2004) and P.L. 105-34 (1997).

[41] *See* Regs. §1.367(d)-1T(c)(3) (useful life); Regs. 1.367(d)-1T(g)(2) (deemed sale of operating intangibles).

[42] The transfer pricing regulations addressing transfers of intangible property and cost sharing arrangements were revamped first in the mid-1990s following a congressionally mandated study of the transfer pricing rules, and again in the last 10 years.

[43] For a comprehensive set of recommendations regarding the regulations project, see New York State Bar Association Tax Section Report on Section 367(d) (October 2010).

[44] *See* Joint Committee on Taxation, ''Present Law and Background Related to Possible Income Shifting and Transfer Pricing,'' JCX-37-10 (7/20/10) (''JCT Income Shifting Report''), at 73–76.

[45] *See* FY 2014 Greenbook, above, note 3 at 51.

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tain approaches to valuing intangible property that are consistent with the post-2009 cost sharing regulations. In particular, the proposal permits the IRS to value intangibles on an aggregate basis in cases where an aggregate valuation of multiple transferred intangibles "achieves a more reliable result," and permits the IRS to value intangibles based on the prices or profits that could have been realized if the taxpayer chose a "realistic alternative" to the related-party transfer of the intangibles. This proposal appears squarely aimed at transactions where the taxpayer attributes significant value of foreign business operations or assets transferred outside the United States to foreign goodwill and going concern value. Because the proposal is described as a clarification, however, the extent to which it is intended to change the historical scope of the active business exception for outbound transfers, in particular the regulatory exception to the definition of intangible property for foreign goodwill and going concern value, is unclear.[46]

The Administration also has proposed legislation to address base erosion more directly and "tax currently excess returns associated with transfers of intangible property offshore."[47] This proposal would create a new category of subpart F income for "excessive returns" of a controlled foreign corporation that is subject to a "low foreign effective tax rate" and that has received intangible property from a related person. Legislative proposals also have come from members of Congress, most notably three alternative proposals to address base erosion in an International Tax Reform Discussion Draft issued by Ways and Means Committee Chairman Dave Camp.[48]

[46] Joint Comm. on Tax'n, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, JCS-2-10, at 279–81 (8/16/10) ("Commentators have also stated that adding goodwill and going concern value to the definition of intangible property under section 936(h)(3)(B) obsoletes the exception for foreign goodwill or going concern value set forth in Temp. Treas. Regs. sec. 1.367(d)-1T(b). This conclusion is predicated, however, on the position that specifically identifying goodwill and going concern value as intangible property under section 936(h)(3)(B) is a change in law, rather than a clarification of present law, because only a change in the law would render obsolete the (earlier-promulgated) regulation. The description of the proposal as a clarification of (and not as a change to) present law suggests that the proposal is not intended to revoke the exception.") (internal citations omitted). But see Zollo, above, note 16 ("rather than clarifying current law, the proposal would represent a clear change in the law governing outbound transfers of intangible property under" §367(d)).

[47] *See* FY 2014 Greenbook, at 49–50.

[48] Ways and Means Discussion Draft. Note that Chairman Camp's proposal if enacted would result in the deemed incorporation of all foreign branches held by domestic corporations, broadly implicating §367(d).

PURPOSE OF §367(d)

Nonrecognition Provisions in the Cross-Border Context — Historical Background

In the domestic context, the Code has from its earliest days provided tax-free treatment for transfers to controlled corporations and for corporate reorganizations. Congress regarded such transactions as mere "changes in form," and believed that current taxation of such transactions would pose an impediment to routine business restructurings.[49] The Code therefore does not subject to tax "transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."[50]

It did not take long, however, for Congress to recognize that these bedrock principles of the corporate income tax create opportunities for mischief in the cross-border context. Section 367 was enacted, therefore, to close a "serious loophole for avoidance of taxes" in which a U.S. taxpayer could transfer appreciated property to a foreign corporation tax-free in a reorganization or §351 transaction, and ultimately avoid (or at a minimum defer) tax upon a subsequent sale of the property by the foreign corporation.[51] As initially enacted in 1932, §367 provided that a transfer to a foreign corporation would not be eligible for nonrecognition "unless, prior to such exchange or distribution, it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."[52]

Until §367 was amended in 1984, the IRS administered §367 according to a set of ruling guidelines.[53] These guidelines set forth the circumstances in which the IRS would ordinarily issue a ruling that an outbound transfer did not have the avoidance of Federal income taxes as one of its principal purposes. These guidelines generally permitted a favorable ruling in

[49] *See* S. Rep. No. 398, 68th Cong., 2d Sess. 17 (1924); H.R. Rep. No. 350, 67th Cong., 1st Sess. 9 (1921).

[50] *Portland Oil Co. v. Comr.*, 109 F.2d 479, 488 (1st Cir. 1940).

[51] H.R. Rep. No. 708, 72d Cong., 2d Sess. (1932), *reprinted in* 1939-1 (Part 2) C.B. 471.

[52] Revenue Act of 1932 §112(k). Note that the focus of this rule initially was on triggering the built-in gain in assets that subsequently would be sold by the deferral vehicle, and not on assets intended to be used in the transferee's business to generate income.

[53] *See* Rev. Proc. 68-23, 1968-1 C.B. 821.

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connection with an outbound transfer of property to be used in the active conduct of a trade or business in a foreign country, but required gain recognition in the case of specified "tainted assets," including inventory and receivables. In the case of patents, trademarks, or other intangible assets, the ruling guidelines required a toll charge if the intangible would be used in "round trip" arrangements in connection with manufacturing for sale or consumption in the United States, or in connection with a U.S. trade or business. Transfers of intangibles for use in connection with a foreign trade or business generally were not treated as having a principal purpose of tax avoidance and were not subject to tax.[54] Thus, these ruling standards generally did not treat transfers of tangible or intangible active business assets from U.S. persons to deferral vehicles as having an improper U.S. tax avoidance purpose, even though such transactions typically would result in the deferral of U.S. tax on future business income. Rather, such transfers were treated as having an improper U.S. tax avoidance purpose only where they were related to a U.S. business or, in the case of intangible property, where they facilitated manufacturing for the U.S. market.

Traditional Interplay of §482 and the Nonrecognition Provisions

Section 482 permits the IRS to reallocate income or other items among commonly controlled persons in order to more clearly reflect income. The purpose of §482 is to allow the IRS to establish parity between taxpayers under common control and unrelated taxpayers.[55] Thus, the IRS is authorized to allocate income among related parties in order to achieve the same tax results as would have been achieved absent the relationship.

Although the IRS reserves the right to allocate income from transferred property to the transferor under §482 notwithstanding the application of a nonrecognition provision,[56] a transfer of property that satisfies an applicable nonrecognition provision generally confers on the transferee the right to earn the income generated by that property. The IRS has prevailed in overriding nonrecognition provisions only in the limited cases where the transferred property was disposed of by the transferee shortly after the contribution rather than used by the transferee in combination with other property to generate income in its business. For example, in *National Securities*, a parent corporation held depreciated securities that it intended to sell.[57] Apparently because it had no ability to use a resulting capital loss, however, the parent contributed the securities to a subsidiary in a §351 transaction, and the subsidiary instead sold the securities (in the same year) and claimed a loss based on a carryover basis. The court upheld the IRS's allocation of the loss to the parent. Likewise, in *Central Cuba Sugar*, the IRS was successful in applying §482 to override a nonrecognition provision in a somewhat unusual circumstance in which the taxpayer transferred a crop that it had planted to a controlled corporation.[58] The transferor claimed expenses that were incurred in planting the crop (prior to the transfer, which was one described under the predecessor of §361) on its own return, but the transferee corporation reported the income from the crops (which it earned later in the same year) on its return. The IRS successfully used §482 to reallocate the planting expenses to the transferee corporation in order to match income and expenses, and the court upheld the reallocation.

Outside of cases like *National Securities* or *Central Cuba Sugar*, where the transferee disposes of transferred property soon after the transfer, courts have been reluctant to expand the IRS's authority under §482 to reallocate income or other items among persons under common control in a way that would fundamentally undermine the nonrecognition provisions. More generally, the courts have long recognized that §482 cannot be used to negate a substantive provision of the Code or regulations designed to address related

[54] *See, e.g.,* PLR 8404026, PLR 8405004, PLR 8405113; *see also* Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at 94–95 (12/31/82) ("1982 Bluebook") (summarizing IRS ruling guidelines as providing that (1) "transfers to foreign corporations of patents, trademarks, and similar intangibles for use in connection with a U.S. trade or business or with manufacturing for sale or consumption in the United States generally are subject to taxation" under the IRS guidelines, but (2) "[b]y negative implication, transfers of intangibles for use purely in connection with a foreign trade or business or manufacturing for sale or consumption outside the United States generally may not be taxable.").

[55] *See, e.g.,* Regs. §1.482-1(a)(1) ("Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer").

[56] *See* Regs. §1.482-(f)(1)(iii)(A) (permitting §482 allocation "with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031)").

[57] *National Securities Corp. v. Comr.*, 137 F.2d 600 (3d Cir. 1943); *see also* Regs. §1.482-1(f)(2)(iii)(B) (contribution of property under §351 followed by sale of the property subject to §482 allocation).

[58] *See Central Cuba Sugar Co. v. Comr.*, 198 F.2d 214 (2d Cir. 1952) (upholding the Commissioner's §482 allocation of deductions to the transferee-corporation that received the asset that produced the associated income which was recognized by the transferee); *Rooney v. U.S.*, 305 F.2d 681 (9th Cir. 1962) (upholding a similar action taken by the commissioner as in *Central Cuba Sugar*).

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party transactions.[59] In *Eli Lilly*, for example, a U.S. corporation transferred patents and other intangibles to its Puerto Rican subsidiary in a §351 transaction that occurred prior to the enactment of §367(d). The court held that income earned by the subsidiary from exploiting the intangible property and selling manufactured goods to its parent could not be allocated to the parent under §482 because the income was earned by the subsidiary from the use of its property in its business. The IRS argued that the parent's transfer of intangible property in exchange for stock was not an arm's-length transaction and therefore should be disregarded in assessing the pricing of the manufactured goods. The court disagreed, stating that a similar transaction with an unrelated party ''seems perfectly conceivable if the unrelated firm had been able to offer Lilly an equity interest of comparable value, at a comparable level of risk, together with equally valuable technical assistance contracts and exclusive distribution rights.''[60] The court ultimately rejected the IRS's attempt to use §482 to disregard the tax consequences of the §351 transfer because the IRS ''lacked authority under the income distortion prong [of section 482] to negate an otherwise valid section 351 transfer in its entirety.''[61] Thus, where a substantive provision of tax law directly governs the tax consequences of transactions among controlled parties, the IRS may not invoke §482 to preempt the resulting tax consequences.[62]

Enactment of §367(d)

In 1984, Congress undertook an overall restructuring of the rules governing outbound transfers, one component of which was the enactment of a broadly applicable version of §367(d).[63] Congress generally determined that the ''principal purpose'' test of prior law had been narrowly interpreted by courts and was therefore difficult for the government to administer.[64] The 1984 legislation replaced the ''principal purpose'' test with an ''active trade or business'' exception. Under the new law, an outbound transfer of property would be subject to tax under §367 unless the property was transferred for use by the foreign corporation in the active conduct of a trade or business outside the United States.[65] Consistent with prior law, §367(a) generally permitted the tax-free transfer of tangible business assets from U.S. persons to deferral vehicles for use in a foreign trade or business even though such transactions typically would result in the deferral of U.S. tax on future business income.

In addition to the concerns it expressed with the administration and interpretation of the ''principal purpose'' test of prior law §367, however, Congress felt that ''specific and unique problems exist with respect to applying §367(a) to the transfer by U.S. persons of manufacturing and marketing intangibles to foreign corporations.''[66] In particular, Congress was concerned that domestic corporations engaged in outbound transfers of intangible property in order ''to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible.''[67] Moreover, by transferring the intangible to subsidiaries located in low-tax foreign jurisdictions, the domestic corporation could avoid paying foreign tax on intangible profits as well.[68]

The policy underlying §367(d) therefore rests on several characteristics of intangible property that are not associated with tangible property. At the margin, these characteristics provide interpretive tools to help distinguish other property from the intangible property targeted by §367(d). Intangible property is not tied to the jurisdiction of exploitation but rather can be easily moved from its place of development, and

[59] *See, e.g., Eli Lilly & Co. v. Comr.*, 84 T.C. 996 (1985), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Comr.*, 88 T.C. 252 (1987); *Bank of America v. U.S.*, 79-1 USTC ¶9170 (N.D. Cal. 1979).

[60] *Eli Lilly*, 856 F.2d at 863.

[61] *Id.* at 862. Note that under then-current §936, U.S. tax on the income earned by the Puerto Rico subsidiary from its exploitation of intangibles was not merely deferred, but eliminated.

[62] *See also Bank of America v. U.S.*, 79-1 USTC ¶9170 (N.D. Cal. 1979) (concluding that the IRS could not assert §482 to disregard the tax consequences of a transaction governed by former §311 because ''[n]o . . . distortion of income [is] produced by this transfer which is not sanctioned by section 311'').

[63] Section 367(d) was first introduced to the Code two years earlier, but it initially applied only to outbound transfers by a possessions corporation. *See* Tax Equity and Fiscal Responsibility Act of 1982, P.L. 92-248, §213(d), 96 Stat. 452, 465. The 1982 Act was intended to restrict the ability of taxpayers to allocate returns from intangibles to related possessions corporations. Congress enacted §367(d) because it had become concerned that taxpayers would react to these rules by transferring intangibles from possessions corporations to deferral vehicles. *See* 1982 Bluebook, 93–94 (''Congress was aware that, as a result of this legislation, some taxpayers have stated that they would remove investment from Puerto Rico and transfer possession-related intangibles to foreign jurisdictions. Congress believed that such transfers would ordinarily have as one of their principal purposes the avoidance of Federal income tax.'') One can hear the echoes of this history in the concerns expressed by the IRS two decades later regarding §936 exits.

[64] H.R. Rep. No. 432, 98th Cong., 2d Sess. 1315 (1984).

[65] §367(a)(3).

[66] H.R. Rep. No. 432, 98th Cong., 2d Sess. at 1316.

[67] *Id.*

[68] *Id.*

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income from its exploitation may be earned in any geographical location. This feature provides opportunities to migrate intangible property so that returns may escape significant taxation. Further, the costs of developing intangible property may be significant and subject to considerable risk, while the costs of exploiting developed intangible property may be relatively insignificant and risk-free. These up-front costs of development may be currently deductible as research and development or marketing costs even though they contribute to the development of an asset that may have value in the future, further distinguishing the treatment of intangibles from other assets. The purpose of §367(d) is to ensure that U.S. corporations are not able to avoid tax on profits generated by intangibles by shifting those profits to deferral vehicles in low-tax foreign jurisdictions after reducing U.S. taxable income by deducting associated research and experimentation or other development expenses in the United States.

In enacting §367(d), Congress did not view foreign goodwill and going concern value as giving rise to the mismatch of expenses and income that arose when certain other intangible property was transferred outside of the United States.[69] In contrast to other intangibles, ''[g]oodwill and going concern value are generated by earning income, not by incurring deductions.''[70] Further, goodwill and going concern value are tied inexorably to the location of the associated business operations, the income from which would be subject to local tax. They cannot be held by a deferral vehicle in a low-tax foreign jurisdiction and licensed. For these reasons, the legislative history states that ''the transfer of goodwill or going concern value developed by a foreign branch will be treated under [the active trade or business] exception rather than a separate rule applicable to intangibles.''[71] The exception for goodwill and going concern value in the temporary regulations issued in 1986 reflects this legislative intent.[72]

In 1986, consistent with a similar amendment to §482, Congress amended §367(d) to provide that the amounts taken into account from an outbound transfer of intangible property ''shall be commensurate with the income attributable to the intangible.'' Congress amended §367(d) in 1997 to provide that the source of any deemed royalty under §367(d) is consistent with the source of what an actual royalty would be, and in 2004 to provide that a deemed royalty is likewise categorized under §904(d) in the same manner as an actual royalty. None of these amendments evidences a change to the original purpose of §367(d).

Thus, upon an outbound transfer of intangible property, §367(d) treats the transferor as ''receiving amounts that reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property.''[73] The U.S. transferor is required to take into account annually a deemed royalty that reflects amounts commensurate with the income attributable to the intangible.[74] In the event of a later disposition of the transferred intangible, the income inclusion is accelerated and the deemed royalty is treated as received at the time of the disposition.[75]

FRAMEWORK FOR INTERPRETATION OF §367(d)

Interpretation of §367(d) — In General

It is axiomatic that a statute should be interpreted consistent with its intent. As the IRS has acknowledged, ''Congress enacted section 367(d) because it thought it was inappropriate to allow a foreign corporation to earn deferred income from intangible property that was developed by claiming significant ex-

[69] H.R. Rep. No 432, 98th Cong., 2d Sess. at 1317 (''The committee does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system.'').

[70] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (12/31/84) (''1984 Blue Book''), at 428.

[71] H.R. Rep. No 432, 98th Cong., 2d Sess. at 1320. *See also* New York State Bar Association Tax Section Report on Section 367(d) (October 2010), at 47 (''A fair reading of the legislative history of Section 367(d) persuades us that Congress intended to permit the tax-free incorporation of branches with associated goodwill and going concern value, except for [section 936(h)(3)(B) intangibles] and in cases where the branch had accumulated losses subject to recapture'').

[72] *See* Regs. §1.367(d)-1T(b). While the legislative history to §367(d) includes a discussion of items such as goodwill and going concern value that are not intended to be included within the scope of §936(h)(3)(B), it does not provide a satisfying explanation or justification for the use of the §936(h)(3)(B) list in the context of §367(d). This statutory list is nearly identical to the list of intangible property included in the transfer pricing regulations issued in the late 1960s. That list was developed in the context of providing special pricing guidance applicable only to transfers of intangible property. Under those rules, such transfers could be priced only with reference to internal comparable uncontrolled transactions or based on a 12-factor analysis, the first factor of which considered prevailing royalty rates in the industry. It is noteworthy that the contents of the list have not been reconsidered in over 45 years notwithstanding commercial and technological developments as well as the different contexts in which the list has been employed.

[73] 1984 Blue Book at 433.

[74] §367(d)(2)(A)(ii)(I).

[75] §367(d)(2)(A)(ii)(II). Under Notice 2012-39, a U.S. transferor must also recognize a portion of the deemed royalty currently to the extent its shareholders include any ''non-qualified successors'' such as foreign persons.

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penses in the United States."[76] The IRS has referred to this "fundamental policy" in interpreting the scope of §367(d).[77] This policy is consistent with that animating other exceptions to §367(a), notably the recapture of branch losses and non-economic depreciation deductions. As in the case of non-economic depreciation, tax law permits current deduction for intangible development expenses such as research and development and marketing even though such expenses may be connected economically with future income. An assumption underlying the tax accounting rules that favor such expenses by permitting current deductibility is that the system is closed — that is, that the future income connected to the deducted expenses will be included in income and subject to U.S. tax when earned. Thus, the only timing benefit intended is that between the period in which the expenses are incurred and the period in which the associated income is earned. Some intangibles that present this mismatch concern may be easily separated from the active foreign businesses to which they relate and relocated to a low-tax jurisdiction, further exacerbating the issue. Section 367(d), like other analogous exceptions to §367(a), polices this policy in the context of outbound nonrecognition transactions by ensuring a proper accounting before the assets leave the hands of the U.S. transferor. Consistent with the legislative history, these policies are not implicated where the built-in gain in the assets has been generated by successfully operating a business rather than by a timing mismatch, as can be the case with foreign goodwill and going concern value.

The scope of the terms listed in the §936(h)(3)(B) definition of intangibles and foreign goodwill and going concern value is unclear at the margins. Close questions should be resolved in a manner that fulfills the intent of §367(d) while weighing the general policy of nonrecognition of §367(a). Further, while it has not done so to date, the IRS should not hesitate to use its ample authority to exclude items that arguably (or even clearly) are listed in §936(h)(3)(B) from the application of §367(d) in cases where such items do not give rise to the concerns regarding the mismatch of deductions and income that animated the enactment of §367(d).

The application of such an interpretive framework may be illustrated by considering the merits of applying §367(d) to transfers of foreign workforce in place. Assume a U.S. corporation "incorporates" an active business historically operated as a foreign branch, and that the business includes a foreign workforce. As noted above, the IRS has asserted that workforce in place may be a separate asset that constitutes a §936(h)(3)(B) intangible, and therefore may not be covered by the exception for foreign goodwill and going concern value. Further, the Administration has proposed legislation that would clarify this result. Whatever the technical merits of this position under current law,[78] such a result would not be consistent with the purposes of §367(d). To the extent workforce in place is a separate asset,[79] it is not characterized by the features that concerned Congress in enacting §367(d). There is no timing mismatch of expenses and income when the foreign workforce in place of an active business is transferred outside of the United States. Rather, the expenses of maintaining a workforce are continuous and contemporaneous with the generation of income from the business, and the workforce becomes valuable only to the extent that the business itself is successful and generates income. In this regard, workforce in place is highly analogous to goodwill and going concern value. Further, a workforce in place often is tied inexorably to a physical location or facility (e.g., manufacturing facilities or local offices servicing local customers), another feature that distinguishes it from the types of mobile intangibles that led to the enactment of §367(d).

In contrast, excluding from §367(d) foreign goodwill or, more precisely, going concern value attributable to a collection of §936(h)(3)(B) intangibles does not seem consistent with the purposes of §367(d) to the extent the underlying intangibles themselves give rise to mismatch concerns. If the outbound transfer is limited to a portfolio of §936(h)(3)(B) intangibles (e.g., a portfolio of interrelated patents), it seems inappropriate to treat the value attributed to the combination of such intangibles differently than the intangibles themselves.[80] To the extent there is a potential for mismatch of expenses and income with regard to each §936(h)(3)(B) transferred, that potential is exacerbated when they are put together in a manner that adds value. In this context, the Administration's proposal to permit §936(h)(3)(B) intangibles to be valued in the aggregate seems consistent with the intent of

[76] TAM 200907024.

[77] *Id.*

[78] For two views on the technical question, see Bowen, above, note 16 (arguing that workforce in place is not a §936(h)(3)(B) intangible) and Zollo, above, note 16 (same).

[79] The IRS has used the term "workforce in place" to describe various attributes, including the provision to a foreign subsidiary of access to an experienced U.S. research team. *See, e.g.,* Cost Sharing CIP, above, note 1. The characterization of an agreement by one person to provide services in the future to another person as a transfer of property is dubious, even when that agreement is favorable to the recipient.

[80] *But see Veritas Software Corp. v. Comr.*, 133 T.C. 297 (2009) (concluding that the valuation of pre-existing software made available to a foreign affiliate in the context of a cost sharing arrangement must focus on the software itself and not on synergies between the software and other assets or capabilities).

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§367(d). In more complex (and typical) cases where §936(h)(3)(B) intangibles are transferred along with significant tangible trade or business assets, there is a tension between valuing the §936(h)(3)(B) intangibles in the aggregate and the clear Congressional mandate to exclude foreign going concern value from the application of §367(d).

More broadly, as a factual matter, some §936(h)(3)(B) intangibles simply do not raise the concern regarding mismatch of income and expenses. This typically would be the case with operating intangibles, defined under the temporary regulations as intangibles that typically would not be transferred or licensed to third parties for consideration contingent on the use of the property, as well as for local marketing intangibles that are closely tied to foreign business operations and therefore goodwill.[81] An example of an operating intangible might be know-how specific to a particular manufacturing facility; an example of a local marketing intangible might be local customer relationships. In general these intangibles, like goodwill or going concern value, derive their value from the generation of income by the business to which they are inexorably tied. Similarly, some intangibles do not have a long development or start-up period where significant expenses are incurred prior to the generation of income; in the case of these intangibles, in general the expenses associated with such intangibles in any particular period are closely matched to the income generated by the intangibles. Again, know-how associated with a particular manufacturing facility is an example of this, particularly if the know-how is developed in the context of conducting the manufacturing activities. Although customer relationships might be developed during a start-up period where the business is experiencing losses, the rule requiring the recognition of gain to the extent of recapture of branch losses seems a more appropriate mechanism for addressing this issue than §367(d) given the close relationship between local customer relationships and the goodwill of the business. Another example of what is an intangible that generally does not implicate a potential mismatch between income and expenses might be a long-term supply contract in the context of a particular manufacturing facility that becomes favorable due to a change in local market conditions. Income from such a contract in any particular period typically is associated with the expenses in that period, and not expenses in prior periods.

It is difficult to articulate a policy rationale for applying §367(d) to these types of operating intangibles and at the same time permitting built-in gain in the related tangible business assets themselves to go untaxed when transferred outbound. The general policy of permitting outbound tax-free transfers of active foreign businesses in this context seems more applicable than the specific policy of §367(d). Further, as a practical matter it may be very difficult to segregate the value of intangibles from the value of the related tangible property or the remainder of the business. Congress provided ample regulatory authority to exclude classes of §936(h)(3)(B) intangibles from the application of §367(d) in cases like these, presumably where such exclusion furthers the purpose of §367(d).

Using §367(d) to Support Other Policies

One possible rationale that may support not exercising regulatory authority to exclude classes of §936(h)(3)(B) intangibles from the application of §367(d), or otherwise interpreting the §936(h)(3)(B) list as broadly as possible so as to stretch the scope of §367(d), is that such actions may further the policies of other provisions. Section 367(d) often is seen as a backstop to two related sets of rules: (1) the transfer pricing rules, which ensure that income cannot be shifted from U.S. persons to foreign affiliates; and (2) the subpart F rules, which ensure that U.S. persons cannot use foreign subsidiaries to defer tax on certain passive or other income that should be subject to current U.S. tax. In general, consistent with the fairly modest purpose of §367(d), caution should be exercised in using §367(d) as a backstop to these more general international tax rules. Section 367(d) has a more meaningful role to play in ensuring that the application of domestic corporate tax rules to cross-border transactions does not undermine basic international tax principles, although the results of using §367(d) for such purposes may be unsatisfying.

Transfer Pricing Policies

As noted above, the transfer pricing rules are intended to prevent income shifting by clearly reflecting the income of each person involved in transactions with persons under common control. In general, this is done by testing the income of each commonly controlled participant against the income that such participant would have earned had the transactions been at arm's length with uncontrolled persons, thereby establishing tax parity between taxpayers under com-

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[81] *See* Regs. §1.367(a)-1T(d)(5(ii) (definition of operating intangibles) and New York State Bar Association Tax Section Report on Section 367(d) (October 2010), at 56–58 (viewing legislative history of §367(d) as an ''invitation to Treasury and the IRS to exercise regulatory authority in a manner that would exclude from Section 367(d) marketing intangibles that are clearly associated solely with a foreign business and that have not previously been the source of deductions which have reduced United States income'').

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mon control and unrelated taxpayers.[82] Under this standard, longstanding case law provides that taxpayers may decide which entity within a controlled group will conduct a business, or take on a business opportunity, without compensation owing to any other entity.[83] In other words, in the absence of a transfer of property or the performance of a service, the mere allocation of a business opportunity within a controlled group is not a compensable transaction, even in the case of a reallocation of a business from one entity to another. This principle is consistent with international norms.[84] Section 367(a) reinforces this principle by permitting a U.S. person generally to transfer active foreign business assets to a foreign affiliate in a nonrecognition transaction except where there is an overriding policy justification for accelerating the recognition of built-in gain in the transferred assets. The policy justification supporting the exception to this general treatment in §367(d), as well as certain other contexts, is the mismatch of expenses and income characteristic of certain intangibles. These rules are intended merely to claw back any U.S. tax advantages gained related to the assets transferred or from operating in branch form, and not to impose a general exit tax on U.S. persons seeking to incorporate foreign branch operations or otherwise transfer foreign business assets outbound. The transfer pricing rules and policies underlying them do not appear to provide any additional support for expansively interpreting the scope of §367(d), or for declining to exercise the authority to curtail the scope of §367(d) in appropriate circumstances.

Anti-Deferral Policies

Almost invariably, the foreign transferee of an outbound transfer will be a deferral vehicle — i.e., an entity whose income is neither subject to U.S. income tax nor subpart F income that is taxable to the transferee's U.S. shareholders when earned. Policymakers have expressed intermittent concern that the subpart F rules are not operating as intended and permit deferral of U.S. tax in cases that are inappropriate, in particular when those rules are applied in combination with the entity classification rules.[85] Using §367(d) to ameliorate these perceived shortcomings has some superficial appeal, particularly given the legislative history expressing concern that intangibles may be transferred to low-tax jurisdictions and therefore be subject to limited foreign tax. Indeed, of all the exceptions to the active trade or business exception of §367(a)(3)(A), §367(d) arguably is best tailored to support anti-deferral policies. Unlike the other exceptions to §367(a)(3)(A), that either trigger the recognition of realized gains or the recapture of losses or deductions as of the time of the transfer, §367(d) requires the inclusion when earned of future business income attributable to the intangible property transferred. Under the statutory commensurate with income standard, such income inclusions may not be limited to the built-in gain in the transferred assets at the time of the transfer. Income inclusions under §367(d) are in some ways akin to subpart F inclusions — in each case, the general rule of deferral is turned off in favor of a current inclusion regime. On balance, however, concerns regarding the perceived shortcomings of the subpart F rules do not provide any additional support for expansively interpreting the scope of §367(d), or for declining to exercise the authority to curtail the scope of §367(d) in appropriate circumstances, for two reasons.

First, attempting to correct perceived deficiencies in the subpart F rules through aggressive interpretations of §367(d) would result in an uneven application of the anti-deferral rules across similar fact patterns.

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[82] *See generally* Regs. §1.482-1(a) and (b).

[83] *See Merck & Co. v. U.S.*, 24 Cl. Ct. 73, 88 (1991) (rejecting IRS contention that U.S. company transferred intangibles to a foreign affiliate upon the allocation of business opportunity from a domestic affiliate to that foreign affiliate, stating that the arrangement involved "no more than a recognition that Merck is the parent of the foreign affiliates and [the domestic affiliate]. A parent corporation may create subsidiaries and determine which among its subsidiaries will earn income. The mere power to determine who in a controlled group will earn income cannot justify a Section 482 allocation from the entity that actually earned the income."); *see also Hospital Corp. of America v. Comr.*, 81 T.C. 520 (1983) (no transfer of intangible property where U.S. company made business opportunity available to foreign affiliate, but compensable services where U.S. company negotiated the relevant contract and permitted its affiliate to use its system for hospital management).

[84] *See* OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, ¶9.65 (July 2010) ("An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. When applying the arm's-length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation would be compensated between independent parties in comparable circumstances.")

[85] *See, e.g.,* U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (May 2009) at 28 (proposal to "Reform Business Entity Classification Rules for Foreign Entities") ("In certain cases, locating a foreign disregarded entity under a centralized holding company (or partnership) may permit the migration of earnings to low-taxed jurisdictions without a current income inclusion of the amount of such earnings to a U.S. taxpayer under the subpart F provisions of the Code"). *See also* Notice 98-11, 1998-1 C.B. 433 (withdrawn by Notice 98-35, 1998-2 C.B. 34); former Prop. Regs. §301.7701-3(h), 64 Fed. Reg. 66591 (11/29/99).

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Taxpayers that began foreign businesses in branch form would be subject to more onerous treatment than those that began those businesses as foreign corporations or branches of foreign corporations. Whatever the weaknesses in the subpart F rules, they are present in either case. What may be different is that in the first case there may have been U.S. tax advantages to operating in branch form, such as the deduction of branch losses or intangible development expenses, while such advantages are absent in the second case. Consistent with its intent, §367(d) should be administered in a manner that focuses on this dynamic. The use of a commensurate with income approach, rather than a recapture of intangible development costs, is not inconsistent with the view that §367(d) is intended to address the same dynamic as the rules requiring the recapture of branch losses or non-economic depreciation. The commensurate with income standard may more appropriately address this mismatch concern in the case of intangibles than a recapture of intangible development costs because of the difficulty in determining the scope of intangible development costs attributable to the development of successful intangibles, particularly where there is significant risk that any single development project will be successful and therefore returns on successful projects must support the costs of unsuccessful projects.

Second, the results under §367(d) are different, and generally more burdensome, than the results where the subpart F rules are triggered. If applied expansively, §367(d) has the potential to subject the U.S. transferor to U.S. tax on all expected future income from a foreign business activity other than a routine return on tangible assets and functions, without regard to the character of such earnings or whether such earnings are repatriated.[86] Further, although the deemed royalties under §367(d) are foreign source, for purposes of the foreign tax credit rules they are not accompanied by foreign taxes paid by the foreign business on the income it actually earns. In contrast, subpart F inclusions are limited to certain categories of operating income and carry with them any foreign taxes imposed on such income. In short, perceived deficiencies with the subpart F rules should be addressed by changing the subpart F rules as appropriate, and not by expansively interpreting §367(d).

More generally, under current law U.S. corporate taxpayers have the choice of operating their active foreign businesses in branch form or in deferral vehicles.[87] It is well understood that different results are achievable in each case. For example, deferral of U.S. tax is possible through the use of deferral vehicles but not branches, while losses of a foreign branch (but not a deferral vehicle) may be offset against U.S. income. Section 367(a)(3)(A) applies at the border of these two regimes, governing incorporations of active foreign business branches into, or other transfer of active foreign business assets to, deferral vehicles. The legislative history of §367(d) and the other exceptions to the general nonrecognition rules of §367(a)(3)(A) strongly supports the conclusion that these rules are intended to claw back the U.S. tax benefits of having operated in branch form, effectively preventing tax arbitrage of the two systems of operations. There is little support for the proposition that these rules should be interpreted in a manner so as to shore up perceived gaps in the anti-deferral rules. It is the anti-deferral rules of subpart F, and not the rules of §367, that determine the extent to which U.S. tax on income earned by a controlled foreign corporation must be included by the U.S. owner when earned.

Nonrecognition Rules and Cross-Border Transfers

The longstanding and historical purpose of §367 is to coordinate the nonrecognition rules of the domestic corporate tax system with the specific concerns raised in the cross-border context. Section 367(d) manifests this broader purpose: whereas in the context of a domestic nonrecognition transfer, it is permitted and appropriate for the domestic transferee corporation to earn income with respect to assets that have been transferred, this principle creates opportunities for inappropriate results if extended to all outbound transfers. It can be argued that the application of §367(d) in Notice 2012-39 merely effectuates this broader purpose of adapting the domestic corporate tax rules to the cross-border context. According to this view, the ''boot within gain'' rule of §356 inappropriately permits tax-free repatriation in the case of outbound transfers, and §367(d) can be utilized to curb this objectionable technique, at least when the transfer involves intangible property. Characterizing the boot as

[86] As noted above, the IRS has expressed the view that if the key intangible property to be exploited in foreign markets originated in the United States, then the consideration owing to the transferor in a taxable transaction should equal all non-routine returns from the foreign venture, in perpetuity, expected at the time of the outbound transfer. *See, e.g.,* Preamble to 2009 Temporary Cost Sharing Regulations, 74 Fed. Reg. 340, 345 (1/5/09) (describing application of income method to transfer of intangible property as providing the transferor with all returns from the intangible property to be developed in the cost sharing arrangement following the allocation of routine returns to the transferee).

[87] The legislative history to §7701(o) acknowledges, for example, that ''a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment'' is one of several ''basic business transactions that, under longstanding judicial and administrative practice are respected'' and not therefore subject to recharacterization under the economic substance doctrine. *See* Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the ''Reconciliation Act of 2010,'' as amended, in Combination with the ''Patient Protection and Affordable Care Act,''* JCX-18-10 (3/21/10), at 152.

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a prepayment on the deemed royalty under §367(d) ensures that the U.S. transferor is taxed once on the repatriated amounts in accordance with sound international tax policy.[88] Note that in cases where boot would otherwise be taxed as a dividend under §356 (because the gain limitation does not apply, or in the event that the ''boot within gain'' rule is repealed), this logic would suggest that the boot should instead be characterized as a prepayment of a deemed §367(d) royalty, in order to prevent the U.S. transferor from being taxed twice.[89] In effect, treating boot as a prepayment of a deemed royalty should remove the boot from the ordinary corporate tax rules entirely so that it is no longer subject to §356 at all and is neither non-taxable boot under the ''boot within gain'' rule nor a dividend under §356(a)(2).

On the other hand, there is no particular policy under §367(d) that supports the result of Notice 2012-39 because it is the boot within gain rule, rather than §367(d), that permits tax-free repatriation if the shareholder has no gain in its target stock.[90] In the case of outbound transfers subject to §367(d), prior to the Notice the boot within gain rule coupled with the deemed royalty rule of §367(d) permitted a U.S. taxpayer effectively to repatriate the same amounts twice, first as boot and then as a deemed royalty, while being subject to U.S. tax only on the deemed royalty flow. In the case of outbound transfers of property other than §936(h)(3)(B) intangibles, the boot within gain rule may not have enabled tax-free repatriation because, under §367(a)(5), the receipt of boot may cause gain recognition to the extent the inside asset gain of the U.S. transferor cannot be preserved in the stock of the transferee foreign corporation.[91] This distinction merely reflects the different ways in which §367(a) and §367(d) operate: on the one hand, §367(a) taxes the amount of gain in tangible property, and on the other hand, §367(d) taxes intangible property based on a deemed royalty over the useful life of the project. On balance, it is difficult to object to the result of Notice 2012-39. But the process for arriving to that result — using the authority of §367(d) as a half measure to address a more fundamental issue under §356 — leaves something to be desired.[92]

FACTORS TO CONSIDER IN MAKING POLICY IN THE AREA

Policymakers of course are free to amend §367(d) to better reflect appropriate policies in light of commercial or legal developments, perceived taxpayer abuses, overreach by the IRS, changes in judgment, or any other development. Coherent policymaking in the international tax area is notoriously difficult because the rules historically have been intended to achieve two conflicting objectives. One objective is to protect the U.S. tax base. In general, the international tax rules are not intended to permit U.S. taxpayers to reduce the U.S. taxes on income from U.S. operations. The transfer pricing rules and the subpart F rules are important components to achieving this objective — income actually earned by a U.S. person should not be treated as earned by a foreign deferral vehicle, and deferral should be limited to foreign business income that has a nexus with real foreign business operations. Section 367(d) and the other exceptions to the general rule of nonrecognition on outbound reorganizations also have an important role here. To the extent deductions or losses are taken against U.S. income, the associated income should be subject to U.S. tax on a current basis.

A second important objective of the international tax rules is to preserve and promote the competitiveness of the U.S. economy by ensuring that U.S. persons can compete abroad on a level playing field with foreign-based or local competitors. Accordingly, deferral of U.S. tax is permitted on certain active foreign business income to equalize the taxation of such income with that of foreign-based or local competitors, and a foreign tax credit is provided to mitigate the potential that the same income is taxed twice. Section 367(a)(3)(A) has an important role here by generally permitting U.S. taxpayers to incorporate their active foreign businesses without facing immediate U.S. tax on the built-in gain in those businesses, except to the extent necessary to claw back U.S. tax benefits related to the transferred assets or of operating in branch form.

In this regard, policymakers considering whether to amend §367(d) may consider whether the balance struck by Congress in the 1980s is appropriate in the current environment. Perhaps §367(d) should be nar-

[88] On the other hand, if the boot escapes taxation under the boot within gain rule, the U.S. shareholder loses its tax basis in the stock of the U.S. transferor and therefore might be considered to have ''incurred an appropriate tax cost for the receipt of the distribution.'' See Collins, above, note 16.

[89] *See* New York State Bar Association Tax Section Report on Section 367(d) (October 2010), at 72–73.

[90] As noted above, the Administration has proposed repeal of the boot-within-gain rule. *See* FY 2014 Greenbook, at 91.

[91] *See* Regs. §1.367(a)-7(c)(2)(ii).

[92] Notice 2012-39 can be thought of as the latest in a string of positions taken by the IRS to address tax-advantaged repatriations under the authority of provisions that were not necessarily designed to address such issues. *See generally* Joseph M. Calianno and Brad Rode, Navigating the IRS's Attack on Perceived Repatriation Transactions, 39 *Tax Mgmt. Int'l J.* 197 (4/9/10); Collins, above note 16. From a policy perspective, it would be far preferable to establish a more coherent policy in this area through the enactment of statutory changes rather than to attempt to address the issue in a piecemeal fashion.

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rowed and refocused on its original purpose, to prevent taxpayers from deducting intangible development costs against U.S. income and later deferring the tax on income associated with the successful exploitation of the developed intangible property. Such a refocusing would better align §367(d) with the other exceptions to the active trade or business rule of §367(a)(3)(A). In some sense this would be a rearticulation or clarification of the original purpose of §367(d) given that the IRS thus far has declined to exercise its regulatory authority to except from §367(d) intangibles that do not raise the mismatch concern identified by Congress. Perhaps such a change would reduce controversy in this area regarding the scope of §367(d) by better articulating the line between intangibles subject to those rules and intangibles that may be transferred without accelerating recognition of built-in gain pursuant to the general rules of §367(a).

Indeed, perhaps §367(d) should be further narrowed to apply to transfers from U.S. companies to foreign deferral vehicles outside of the branch incorporation context. It is noteworthy that the taxpayer-sympathetic examples above in general involve the transfer of intangibles to deferral vehicles in the context of an incorporation of active foreign business activities initially conducted through a branch. In these cases, the income and the expenses attributable to ongoing business operations likely are taken into account in the tax system of the jurisdiction of the branch. The income from intangibles developed through expenses deductible in the local jurisdiction seems appropriately taxed by the local jurisdiction and not by the United States, and that jurisdiction is unlikely to permit a deduction for any royalty payment given that intangible development costs were deducted in its system. This is the case whether or not the expenses are incurred contemporaneously with the development of the intangible. In such a regime, a rule like §367(d) may be necessary to police transfers of intangible property to foreign branches. Such a rule almost necessarily would be more limited (and perhaps appropriate) in scope than §367(d) as currently administered given that operating intangibles typically would be developed by, rather than transferred to, a foreign branch.

Conversely, perhaps §367(d), along with the other exceptions to nonrecognition treatment in §367(a), should be expanded to address more directly base erosion concerns. For example, §367(a) could provide that the outbound transfer of any asset or business that has the potential for non-routine profits should trigger a U.S. tax on those profits (either at the time of the transfer or as the profits are realized). The positions taken by the IRS in controversies in this area could be characterized as efforts to reach this result in cases perceived as abusive. Perhaps such a rule could be limited to cases perceived by policymakers as raising particular U.S. international tax policy concerns, such as the transfer of intangible or similar property for use in manufacturing goods outside the United States that are destined for the U.S. market. A focus on round-trip transactions would better align §367(d) with the former ruling practice and would address concerns expressed by policymakers regarding U.S. corporate groups with U.S. sales that are disproportionately high in relation to U.S. taxable income.[93] There may be sound policy arguments in favor of such proposals. Such changes, however, would represent fundamental changes in policy as they would move §367(a) more in the direction of a true exit tax rather than its historical role of generally permitting the tax-free incorporation of active foreign businesses. Such fundamental changes should not be taken lightly.

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[93] *See* JCT Income Shifting Report at 117; *see also* Ways and Means Discussion Draft (proposing as base erosion Option C to tax as subpart F income amounts earned by CFCs from intangibles derived in connection with property sold or used in the United States, or in connection with services provided to persons or property in the United States) (October 2011).

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